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THE SCOURGE OF RATINGS AGENCIES

ECONOFICTION CAPITAL, FINANCE, MARXISM, NON-ECONOMY, RATING AGENCIES

This is from the archives written over two days in August and September this year and meant as part of the weekly digest for **PFPAC (FB)**.

Some days back, a friend, asked a question on Ratings Agencies (RAs hereafter), and if there is anything viable or subsequently pliable of these? So, this is a delving into the world of RAs, with a due note of caution that the piece is liable to technical morass. I don't think I can help emaciate that, and so readers not too glued to technicalities can happily "skip" this. Another caveat here is the number of loose ends rooting and branching out to nowhere, or rather everywhere, for, the **political of the neoliberal** is an all-encompassing compass far larger than adherence to revolutionary struggles of the peripherals, and rooted in nodal points and events that bring such thoughts to fruition in the first place. RAs' political economy ties in perfectly with the neoliberal and financialisation of capital in stitching these loose ends. So, it is time to go back to man is the political animal (Reasoning) of Aristotle from the present-day cow is the political animal of scores and scores (Pun intended!)...

Lets begin with **indemnities**, the technical parlance for insurance, wind and wade through probabilities and reach a designated '**credit police**', for this is where historical roots of RAs lie. **Edmund Halley (Yes, the same astronomer giant credited with the eponymously-named comet!)** in 1693 is credited with publishing the first-ever mortality tables based on the parish records for the Polish-German town of Breslau showing a mortality rate of 1 in 30 every year. These figures corroborated to a setting aside of a thirtieth of a company towards life insurance and annuities, whereby anyone investing in to this fraction by a company would be a policyholder, a member of the population subject to patterns of death and disease, and measured, averaged and thus risk-managed. Below is the original table that Halley came out with.

Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.
1	1000	8	680	15	628	22	585	29	539	36	481	7	5547
2	855	9	670	16	622	23	579	30	531	37	472	14	4584
3	798	10	661	17	616	24	573	31	523	38	463	21	4270
4	760	11	653	18	610	25	567	32	515	39	454	28	3564
5	732	12	646	19	604	26	560	33	507	40	445	35	3604
6	710	13	640	20	598	27	553	34	499	41	436	42	3178
7	692	14	634	21	592	28	546	35	490	42	427	49	2709
Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.	Age. Curt.	Per- sons.
43	417	50	346	57	272	64	202	71	131	78	58	77	692
44	407	51	335	58	262	65	192	72	120	79	49	84	253
45	397	52	324	59	252	66	182	73	109	80	41	100	107
46	387	53	313	60	242	67	172	74	98	81	34		
47	377	54	302	61	232	68	162	75	88	82	28		
48	367	55	292	62	222	69	152	76	78	83	23		
49	357	56	282	63	212	70	142	77	68	84	20		
												34000	
												Sum Total.	

Now, if an insurance company brought together a large enough pool of policyholders, individual uncertainty was almost magically eliminated, so long as the **actuary** did his math correctly. The math isn't really subjected to individual vagaries, but culminates in an objective reality, an often debated and nuanced extreme of statistical probability theory based on data analysis. So far, so good. But, how does this augur with banking and finance? Analogising the death-disease parametric of insurance with bankruptcy and default of banking and finance, there is a relationship of equivalence to be drawn here. Just like insurance is subject to probability over long periods of time, a bank with a loan portfolio is played upon equivalently by probability over long periods of time, and both of these draw parallels in alleviating anxieties, or eliminating risks.

Jumping over from insurance. There is a catch here. Actuaries could potentially be instrumental in reducing risks or anxieties through their mathematical genius, but would that mean a trade-off with risk assessments, or due diligence as the latter is gaining currency? As in the case of insurers, who would require a bonafide 'health certificate' before bestowing policies, banks too would require such certification (**at least ideally that is how it is supposed to work**). Enter "**Credit Police**". As **Nicholas Dunbar** in his **The Devil's Derivatives** says of them: these might be the credit officers at a bank or, more ubiquitously, a credit ratings agency paid by the borrower to provide them with "health certificate". Instead of an actuary counting deaths, lenders can turn to a RA to count defaults and crunch the numbers.

This brings us to the definition of RAs: Rating agencies, or credit rating agencies, evaluate the creditworthiness of organisations that issue debt in public markets. This includes the debts of corporations, nonprofit organisations, and governments, as well as "securitised assets" – which are assets that are bundled together and sold as a security to investors. Rating agencies assign a letter grade to each bond, which represents an opinion as to the likelihood that the organisation will be able to repay both the principal and interest as they become due.

The first ratings agent (credit police) in the world is often considered to be a financial journalist, who went by the name John Moody, whose interests in the American railroads in the earliest part of the 1900s led him analytically to opining on uncertainty on bonds, wherein all it required was scouring public records in determining what was really owned and how was it being performed. But, there seemed to be a parallel action in the form of Henry Poor's firm that had been doing something similar fifty years before Moody sprang on to the scene. But, what really distinguished Moody from Poor and made the former a credit police was categorising the companies into creditworthiness. These categories is what is almost followed universally even today, and were alphabetically-based. 3 As (Triple A) was the elitist of these categories with a credit standing to the mighty USA itself. This was followed by 2 A (Double A), 1 A or just A (Single A), and B (similar sub-divisions), C (similar sub-divisions) and finally D, or Default. But, Moody drew another distinction, viz. Bonds above **Ba** rating were called investment grade, whereas below **Ba** were termed speculative grade. It is to be noted that investment graded-Bonds have a minimal risk of default, whereas speculative grade issue or issuer ratings are all ratings below BB+ or Ba+ included, down to CC-. Speculative grade or sub-investment grade issues can be considered "less vulnerable in the short run but face major uncertainties and exposures to adverse business, financial and economic conditions" (BB) or "subject to substantial credit risk" (Ba), to "a marked shortcoming has materialised" or 'typically in default' (C). Speculative grade ratings are also called junk bonds. Moving on, what Moody did was sort sheep from the goats, in that, he promulgated investment grades as having a less chance of defaulting compared to speculative ones, and sold his bond ratings via a subscription newsletter winning trust through his analysis.

So, how does statistics/probability that tames uncertainty also quantify and qualify the loss? Dunbar makes a compelling argument. A portfolio of bonds of a particular grade would need to pay an annual spread higher than that of a risk-free cash investment, to compensate for the average default rate for bonds. In the same way that life insurance premiums vary according to the age of the policyholder, there is a credit spread for a particular rating of a bond – so, for example, bonds rated **Baa** by Moody's should pay about a **quarter of a percentage (Caution: pdf)** in additional interest to make up for expected defaults over time. If you make it your business to lend money to a large number of Baa-rated companies, then on average, over time, your business will theoretically break even – as long as you charge these companies at least a quarter of a percent more a year than the loan rate enjoyed by the Government. Investment grade companies re happy to pay this premium in return for borrowing

money, and the spread earned on corporate bonds or loans is typically a multiple of the statistical default loss rate. Such actuarial approaches work if investments are not given up on prematurely. Moreover, default rates could fluctuate year-to-year even under the consideration of the stability of long-term average, but helps in riding out a recession by waiting for the good loans in your portfolio balancing out the losses over time. This is where **RAs get political**, for the actuarial approach set forth by them is through the cycle to describe their ratings, to legitimise their analysis, to reassure the implication that their actuarial approaches were recession-proof.

This political toning isn't really a theoretic, as journeying back into history has ample attributions to elevating RAs in tune with their stellar reputations to a sinecure by US regulators. Forwarding by six decades, the integrity of these RAs twisted from charging investors to charging issuers. As the value of the rating agencies derives from their reputation for independent credit analysis and reporting, the issuer-pay model poses definite problems for independence, at least in appearance, starting with the questions of partiality. The perception of such potential conflicts of interest may partly explain why S&P did not choose to follow Moody's and extend its issuer-pay model to corporate bond issuers in 1970. At the time of Moody's announcement, S&P declared, "the income from the publications that carry our ratings and the expansion of our commercial paper rating activity enable us to provide corporate bond ratings without charge at this time". Moody's and S&P's ability to successfully implement an issuer-pay model reflects their market power and reputational capital. However, when the **SEC** (US Securities and Exchange Commission) recognized Moody's and S&P as Nationally Recognized Statistical Ratings Organizations in 1975, this directly increased the regulatory use of credit ratings and gave the two agencies enormous power and prestige. Very likely, this designation also made the issuer-pay model sustainable. Although many technological and economic factors led to the switch from investor-pay to issuer-pay fees for credit ratings three decades ago, the question of whether this revenue model is associated with actual conflicts of interest remains an empirical one. Recent rating down-grades for bonds rated Aaa prior to the financial crisis have led some to speculate that the issuer-pay model has weakened rating agencies' due diligence and led to poor quality ratings. Both Congress and the SEC have considered ways to change the issuer-pay model. Although the newly passed **Dodd-Frank Wall Street Reform and Consumer Protection Act** does not address the issuer-pay model, it requires the **Government Accountability Office** to prepare a study of alternative ways of compensating rating agencies. It also asks the SEC to adopt new rules concerning the conflicts of interest that arise from rating agencies' sale and marketing practices.

In light of the above controversy, rating agencies contend that their concerns for reputation discourage them from engaging in any short-term opportunistic behavior. Indeed, Moody's claims, "We are in the integrity business", and S&P takes it one step further, claiming, "Our reputation is our business". The SEC concurs: "The ongoing value of a rating organization's business is wholly dependent on continued investor confidence in the credibility and reliability of its ratings, and no single fee or group of fees could be important enough.".....

But, what of countries? How are they given sovereign ratings and why should they even matter? Countries are issued sovereign credit ratings. This rating analyzes the general creditworthiness of a country or foreign government. Sovereign credit ratings take into account the overall economic conditions of a country including the volume of foreign, public and private investment, capital market transparency and foreign currency reserves. Sovereign ratings also assess political conditions such as overall political stability and the level of economic stability a country will maintain during times of political transition. Institutional investors rely on sovereign ratings to qualify and quantify the general investment atmosphere of a particular country. The sovereign rating is often the prerequisite information institutional investors use to determine if they will further consider specific companies, industries and classes of securities issued in a specific country. More governments with greater default risk and more companies domiciled in riskier host countries are borrowing in international bond markets. Although foreign government officials generally cooperate with the agencies, rating assignments that are lower than anticipated often prompt issuers to question the consistency and rationale of sovereign ratings. How clear are the criteria underlying sovereign ratings? Moreover, how much of an impact do ratings have on borrowing costs for sovereigns?

Ratings Agency is a company that specialises in evaluating a company's or government's ability to repay debts, which in a technical jargon is creditworthiness. Although, they mainly give ratings to debt instruments like corporate and sovereign bonds, they could also be involved in doing something similar to commercial loans. These agencies are sustained by charging fees from corporations or governments and selling their analysis to public at large. Although credit rating agencies are private firms, their role in financial regulatory frameworks has expanded since the 1970s – especially as a result of an international agreement to assess bank portfolios based on the risk of their assets and set capital requirements accordingly. This so-called Basel II Accord sought to add nuance to regulatory standards. A key justification for the incorporation of rating agencies' credit assessments was the belief that they offered a more sophisticated approach to measuring credit risk than did the simpler regulatory practice of basing capital requirements on a fixed percentage of total assets – the approach in the earlier Basel I Accord, which allowed for much less differentiation.

Prior to the era of project financing, debt financing by banks was the mainstay of funding, where the onus of assessing the risks associated with credit lay ultimately with the funders/lenders, i.e. the banks themselves. But, one of the bridges that linked debt financing to project financing was the instrument of bonds, whose meteoric rise has been coterminous with RAs' density of indispensability. When any prospective bond buyer assesses the risks involved with transacting bonds, she would rely on the analysis provided by these RAs. So, if one looks keenly into this logic of transactions, it becomes quite sensible to derive the fact that corporations would indeed want to be rated according to their aspirations to stay on in the business. But, when Governments take this leap, it is a slight misnomer to feel it that way common-sensical. But, alas! no, governments become part of the process

of ratings simply by way of fact that many of these sovereign entities raise money on capital markets.

A borrower's economic outlook is taken into consideration by performing industry studies to assess how a particular industry would evolve and how profitable a company will be in future. It is then culled with borrower's management. For instance, a country with massive debts and a government that is unlikely to take actions to reduce them would attract a lower rating. Now, why is this important is by ascribing to the fact that it affects expressivities of investment climate by fluctuating between borrowing costs. For example, pension funds are often allowed to hold bonds rated at investment grade. A lowering in a na insurer's rating can thus have an enormous effect if pension funds have to sell those assets. Interestingly, while the talks are on about Basel III, it is the Basel II framework that dictates how banks can use data from RAs to determine how risky loans would be, and thus outline the amount of reserves a bank has to hold against those loans. But, the obvious question being begged here would be: do these RAs never fail? The answer is exactly not as affirmative as it should be. Enron, for instance was never rated to default, but only after a true picture of its financial state emerged, was it lowered. Enron was a giant corporation, and probably didn't have the domino impact that a country, or a group of countries would have had if these RAs went berserk with their determination. Since, for a country, the loss is gargantuan, as it is likely aggravated by directly impacting investors' confidence resulting in an immediate pull out of the region.

The postcrisis debate over the role of credit rating agencies in financial regulation has focused primarily on issues such as conflict of interest and adequacy of performance. Among the questions are how the rating agencies assign ratings, what they rate, and whether ratings fueled the precrisis lending boom and resulting asset bubbles and provoked an opposite and pernicious effect after the crisis. These are valid concerns, but they also underscore how credit rating agencies have become an essential part of the financial system – “hardwired” if you will, in such a way that they take the place of due diligence rather than supplement informed decision making. This hardwiring results, in part, from the investment strategies of banks, investment funds, and other private entities. Primarily, though, it stems from credit rating agencies' institutionalized role in public policy activities – chiefly in banking regulation, but also in areas such as determination of the eligibility of collateral in central bank operations and investment decisions of publicly controlled or operated funds, such as pension funds. The use of agency ratings in financial regulation amounts both to privatization of the regulatory process – inherently a government responsibility – and to abdication by government of one of its key duties in order to obtain purported benefits such as lower regulation costs and greater efficiency and nuance. So, was really is the issue here or what really is the problematic?

1. Credit rating agencies aim to maximize profits and shareholder value. Although they have a powerful incentive to provide trustworthy information, they do not have the same mandate as a regulatory agency charged with providing information in the interest of the public. When the private motive and the public imperative are not fully compatible, there is potential for conflict and confusion. One or both may suffer. If the public imperative suffers, it undermines the credibility of the regulatory process.
2. Even if a rating agency enjoys an excellent track record, the credibility of the regulatory process risks erosion because ratings are inherently fallible; they depend on judgments. In the marketplace, if a credit rating agency crosses a threshold of unreliability, it will lose customers and eventually fail. However, if it is part of the regulatory framework, its mistakes may have severe implications, and even if a poor performer can eventually be removed, how can a credit rating agency fail as long as it is part of the regulatory framework? Who will be liable if the agency's opinions result in distortions – especially if financial institutions end up holding too little capital?
3. Rating changes move markets, affecting the value of assets and thus capital requirements. They also affect whether those assets can be used as collateral. This is not inherently bad (indeed such changes are intended to affect assessments of riskiness and asset prices), but a change may cause sudden destabilization, unnecessarily raise volatility, and/or lead to overshooting of the asset's value, particularly in the event of a downgrade. Ratings changes, then, can cause regulation-induced crises. Moreover, the due diligence of investors whose decisions are tied to ratings (for example, certain pension funds) is diminished or even overridden because of the overwhelming importance of credit ratings.
4. Credit rating agencies have long enjoyed considerable influence over market movements because of the faith placed in them by those who demand their services. The enshrinement of their role in regulation multiplies their potential power. It further distorts competition in an industry that has oligopolistic tendencies, because consumers benefit not only by being able to compare different asset classes under one rating system but also by not having to decipher the methodologies of numerous credit rating agencies.

But, then is a reform possible? And if yes, in what direction?

a. Regulatory enhancement: This would involve modifying existing rules, but keeping credit rating agencies in essentially the same regulatory role. Regulations could be tighter. For example, authorities might require rating agencies to be more open about how they operate. The way they are remunerated might also be changed to resolve conflicts of interest. Fees might be regulated. Governments could establish more effective evaluation and accreditation processes for rating agencies and their methodologies and enhance quality control. Investor boards could be established to request credit ratings, which would keep clients and rating agencies separate. Regulators could acknowledge fallibility and establish acceptable levels of accuracy, although this would raise questions about recourse or compensation when inaccuracy occurs. An alternative might be to regulate private credit rating agencies so extensively that they would become essentially public utilities. This approach would substantially reduce conflict of interest and would cost much less than establishing a new public credit rating agency. It would also raise important questions about how to select a rating agency. Would prospective borrowers be compelled to use a particular agency? Would agencies be asked to volunteer? Would there be a competitive selection process.

b. The public solution: One or more of the private credit rating agencies could be brought under public control, or all private agencies could be excluded from regulatory activity and replaced by a new public agency. The new agency would follow a transparent and approved rating methodology. It would be paid to cover its operating costs, but instead of profit maximization, provision of accurate information to optimize the regulatory process would be its main objective. Setting up such an agency may be beyond the ability of individual countries and could lead to other problems, such as regulatory protectionism. At the same time launching such an agency at the supranational level would be complicated, requiring international cooperation and

considerable good faith. The public solution would resolve certain conflict of interest problems, but arguably would generate new ones with respect to the rating of sovereigns, which would be rating themselves or being rated by an entity they own (wholly or partially). Moreover, a public agency would have to establish credibility and independence from political influence and prove itself a reliable source. It would be costly because it would involve establishment of one or more new institutions. It would also not be immune to problems such as regulatory capture, fallibility of ratings, failures of timeliness, moral hazard, and political repercussions emanating from its decisions. Existing rating agencies would likely suffer a drop in business.

c. Return to simpler capital rules: The role of rating agencies could also be eliminated and regulators could return to a few simple and predetermined capital requirements for borrowers. What is lost in nuance and sophistication would be offset by greater simplicity, and therefore transparency. It would also be more predictable and easier for regulators to apply and monitor. A return to static ratios would eliminate errors in judgment arising from ratings changes, although determination of the ratios would be a significant point of contention. Without private rating agencies' conflicts of interest, transparency and predictability would improve. Greater simplicity would also likely reduce the potential for market participants to evade regulations. However, the simplified capital rules could increase the cost of raising funds and make it harder for some entities to do so, which would curtail financial activity and could impair economic growth. Moreover, because the simpler rules would not differentiate among risks, they could create a perverse incentive for banks to lend more to riskier entities, thus increasing the likelihood of future financial crises. So a simple-rules approach would have to be monitored carefully and implemented in conjunction with other regulatory tools and indicators. Its relative simplicity and lack of institutions render it the cheapest proposal for governments to implement. From a political point of view, any return to simple rules could suggest the failure of the Basel II approach, which supported risk-based capital charges.

d. Market-linked capital charges: This approach would turn to the market to determine the level of capital an institution must hold to support an asset. Instead of a credit rating, the market price would be used to gauge the asset's risk profile. In essence, the amount of capital required to hold a fixed-income security would be related to its yield. The capital required for a security would rise in proportion to its spread over a designated benchmark: the market would determine the risk. Such an approach would remove credit rating agencies from regulation while retaining a sophisticated, transparent, and market-friendly process. Indeed, because market determinations change frequently, capital adjustments could be made more often in a more gradual and nuanced fashion than the credit rating agencies' grade changes, which often lead to sudden, destabilizing movements. But this approach requires deep and liquid markets and might have to be supplemented with minimum and maximum capital charges – turning it into a variant of the simple capital rules option. Additional safeguards during periods of market crisis would require regulators to intervene when prices cross certain thresholds and diverge significantly from underlying values. The market could serve as a guide to regulators, without removing them from the regulatory process – as happens when they rely on credit rating agencies. But there is the potential for manipulation, especially when liquidity is constrained or an asset is traded infrequently and therefore susceptible to volatile movements.

But, who bells the cat after all? Governments have worked to introduce tighter regulation after the Enron collapse in 2001, a case of massive fraud that the rating agencies did not signal. Governments themselves are affected by the ratings they receive from the agencies they regulate. Some suggest this opens up the opportunity for a conflict of interest. The frameworks for bank ratings have become more transparent. When rating government finances, the agencies argue that they are balanced and impartial. Downgrading a country's rating inevitably puts an agency in the firing line, but this doesn't mean they are necessarily wrong to do so. No one can predict the future, and it gets really murky on the financial scene. Credit ratings are assessed by modelling risk of default, not by predicting the unforeseeable. Experience, combined with rigorous procedures, can finely tune risk modelling and increase its reliability, but, ultimately, investors act at their own risk and according to their own judgment. However, credit ratings have the potential for significant social, economic and political fall out. Governments are shaken if their ratings drop. The cost of borrowing rises, interest rates may be affected, and it has an impact on the value of a nation's currency. Many are asking for more transparency in how the agencies evaluate banks and whether this high impact public service should remain in the hands of private operators.

The drawbacks and costs of each option must be weighed against expected benefits—which must be identified and, where possible, quantified. In some ways, it is a case of pick your poison because there will always be risks associated with regulation, and those who are regulated will always find creative ways to evade or subvert rules not to their liking. Any reform of credit rating agencies must be part of a broader revamping of regulation, because many regulatory failings were identified in the aftermath of the 2008 global financial crisis. Moreover, the transition costs of moving to a new system must be examined carefully, because they will surely be considerable. Cost, however, should not become an excuse for inaction – which would perpetuate government failure and erode the credibility of financial regulation. That could jeopardize the health of the financial sector and the economy – both nationally and globally. There is need to strengthen the accuracy of credit ratings agencies and thus reduce systemic risks, which could be brought about by a regulatory authority required to rate them in terms of their performance; such regulatory bodies facilitating the ability of investors to hold RAs accountable in civil lawsuits for inflated to deflated credit ratings safeguarding against the reckless conduct of these RAs; ensuring that RAs institute internal controls and ratings methodologies; and most importantly, these regulatory bodies ensuring that RAs give higher risks to financial instruments whose performance cannot be reliably predicted due to their novelty or complexity, or that rely on assets from parties with a record of issuing poor quality assets. Until then, we are subject to these vagaries and accompanying cause-effects.

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